BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
HASKELL C., JR., AND FELICITAS BILLINGS)

For Appellants: Bullis and Johnson
Certified Public Accountants

For Respondent: Burl D. Lack, Chief Counsel
Israel Rogers, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Haskell C., Jr., and Felicitas Billings against proposed assessments of additional personal income tax in the amounts of $5,280.78 and $1,867.01 for the years 1958 and 1959, respectively.

Haskell C. Billings, Jr. (hereafter "appellant") had been a stockholder in United Housing Corporationsince 1942. When that company was liquidated in February 1956, appellant received unimproved real estate (hereafter referred to as Lots 1, 2 and 3) in exchange for his stock. He reported capital gain on that exchange in his 1956 tax return, indicating that'the property had a fair market value of $37,675.37 at the time it was distributed to him and that the basis of his stock was $5,625.00. Shortly after receiving the property, appellant spent $8,616.02 filling, surfacing and leveling a portion of the land.

Later in 1956 appellant sold approximately two-thirds of this real estate, Lots '1 and 2, under an installment contract, retaining legal title to the entire property. He elected to report the gain on this sale on the installment

basis. Accordingly, in his 1956 and 1957 tax returns appellant reported as gain only a portion of the payments received from the buyers during those years. The percentage reported (74.426 percent) was based upon appellant's profit on the sale of Lots 1 and 2, and amounted to $14,884.83 in 1956 and $2,851.93 in 1957.

In early 1958, when the installment buyers determined they would be unable to use the property as planned because of zoning restrictions, they defaulted on their contract, and appellant repossessed the property. On March 3, 1958, appellant transferred title to Lots 1, 2 and 3 by deed to Billings-Hutchison & Co., a partnership in which appellant held a 25 percent interest. There was no agreement of sale, and the partnership did not set the property up on its books as a partnership asset. Billings-Hutchison & Co. used the property to acquire a construction loan; Before issuing the proceeds of the loan to the partnership, the lending bank deducted $58,042.57 in satisfaction of amounts owed to it by appellant, as an individual, on previous loans. On the partnership books this was recorded as an amount owed to the partnership by appellant.

During the spring and summer of 1958 Billings-Hutchison & Co. paid the defaulting installment buyers of Lots 1 and 2 $28,000, thereby acquiring the buyers' interests in the property and cancelling their obligations to make future payments under the contract. The $28,000 payment to the buyers represented their total payments and interest under the installment contract. This transaction was recorded on the books of the partnership as an increase in the amount owed to the partnership by appellant.

In July 1959 the partnership transferred Lots 1, 2 and 3 to Billings-Hutchison, Inc., a corporation in which appellant owned 25 percent of the stock, for a price of $223,492.57. This sum was treated on the partnership books as an amount due to appellant from the partnership.

In his 1958 and 1959 returns appellant did not report these transactions involving Lots 1, 2 and 3. It was respondent's determination that those dealingshad resulted in capital gains to appellant which gave rise to the proposed additional assessments here being protested.

Respondent first contends that appellant's transfer of the real estate to the partnership in 1958 lacked substance and should be ignored for tax purposes.

It is a well established principle that the incidence of taxation depends upon the substance of a transaction, rather than its form. (Commissioner v. Court Holding Co., 324 U.S. 331 [89 L. Ed. 981]; Griffiths v. Helvering, 308 U.S. 355 [84 L. Ed. 319].) Although legal title to the property was passed to the partnership by a deed dated March 3, 1958, it appears that the beneficial ownership of that real estate remained in appellant until it was conveyed to Billings-Hutchison, Inc., in 1959. (James B. Lapsley, 44 B.T.A. 1105.)

Consistent with this conclusion are the facts that (1) no written agreement regarding the "sale" was ever entered into by appellant and the partnership, (2) there is no evidence that the partnership agreed to-pay any consideration for the property, (3) the property was never entered on the books of the partnership as a partnership asset, (4) when a loan was obtained on the property the lending bank deducted from the loan proceeds amounts owed to it by appellant as an individual, (5) appellant was charged with amounts repaid to the installment buyers of the property, and (6) appellant was credited with the amount ultimately paid for the property by Billings-Hutchison, Inc. Since it appears that the deed to the partnership did not alter the substantive ownership, the deed will be disregarded for purposes of determining appellant's tax liability.

Respondent's next contention is that appellant's repossession of Lots 1 and 2 from the installment buyers in 1958 resulted in capital gain to him in that year. Section 17580 of the Revenue and Taxation Code provides for the computation of gain or loss on the disposition of an installment obligation. Interpreting a similar federal statute, the courts have held that a repossession of property sold and reported on the installment basis, accompanied by the purchase of the buyer's, interest in the property and cancellation of his installment obligation, constitutes a disposition of that installmentobligation within the meaning of the statute, which may result in gain or loss to the seller. (Boca Ratone Co. v. Commissioner, 86 F.2d 9; Eggerman Investment Co., 36 B.T.A. 1196.) This rule is also set forth in respondent's

regulations. (Cal. Admin. Code, tit. 18, reg. 17577-17580(e), subd. (2).) Since we have concluded that, for tax purposes; there was no sale of the property to the partnership in 1958, the purchase by the partnership of the defaulting buyers' interest in the property will be treated as a purchase of that equity interest by appellant. So viewed, the instant case clearly falls under the above stated rule, and we therefore agree with respondent that there was a disposition of the installment obligation by appellant in 1958.

Insofar as it is pertinent to the instant case, section 17580 provides that the measurement of gain or loss on the disposition of an installment obligation shall be the difference between the basis of the obligation and its fair market value at the time of disposition. The basis of an installment obligation is the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

Respondent's calculation of the gain realized by appellant in 1958 on his disposition of an installment obligation follows:

Installment sale price		$150,000.00
Less: Payments received 1956	$20,000.00	
Payments received 1957	3,831.90	23,831.90
Balance due on sale price		$126,168.10
Less: Unreported profit (74.426% of $126,168.10)		93,901.87
Basis of unpaid obligation		$ 32,266.23

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Balance due on sale price		$126,168.10
Plus: Payment to buyers		28,000.00
Fair market value on repossession		$154,168.10
Less: Basis of unpaid obligation	$32,266.23	
Payment to defaulting buyers	28,000.00	60,266.23
Gain on repossession in 1958		$ 93,901.87

Respondent's proposed additional assessment for 1959 is based upon its determination that there was no transfer of Lots 1, 2 and 3 to the partnership in 1958, and that appellant, acting as an individual, ultimately sold all such properties to Billings-Hutchison, Inc., in 1959. Respondent's computation of gain realized on that transfer follows:

Sale price to Billings-Hutchison, Inc.			$223,492.57
Less: Basis of lots 1 and 2		$154,168.10	
Basis of lot 3		15,430.97	169,599.07
Total capital gain on sale			$ 53,893.50

Attacking respondent's computations, appellant asserts that Lots 1, 2 and 3 had a much higher basis than he reported in his 1956 return, the basis which respondent has relied upon. Appellant's argument is as follows: The basis of the property received in the liquidation of United Housing Corporation in February 1956 was its fair market value at the time of the distribution (Rev. & Tax. Code, §17403); the best indication of the value of that property is its sales price; and since two-thirds of the property was sold in October 1956 for $150,000, the value of the entire property must have been $225,000 ($150,000 x 1-1/2). Although a higher value would increase the reportable gain on appellant's acquisition of the property in 1956, any assessment for that year is now barred by the statute of limitations. The higher value and basis would, of course, decrease the gain on the subsequent transactions.

The market value which appellant reported in his 1956 return represents a determination made near the time he received the property and with full knowledge of the subsequent sale which was reported in the same return. Under these circumstances, it is anomalous for appellant to rely upon the sales price to upset his own previous determination. Although the sales price is evidence of the value of the property eight months prior to the sale, it is not conclusive. If the sales price did reflect the value of the property at the time appellant acquired it, then the value first reported by him was a deliberate misrepresentation. We will not assume, for appellant's present benefit, that such a misrepresentation occurred.

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Respondent's proposed assessments for 1958 and 1959, together with appellant's self-assessments for 1956 and 1957, have resulted in taxing to appellant no more and no less than the difference between the entire amount appellant received from the property and the entire amount he invested in acquiring and improving the property. Having reviewed the record carefully, we conclude that respondent's computations of, the capital gain realized by appellant are in conformity with the relevant statutes and regulations. We therefore. sustain the proposed assessments.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Haskell C., Jr., and Felicitas Billings against proposed assessments of additional personal income tax in the amounts of $5,280.78 and $1,867.01 for the years 1958 and 1959, respectively, be and the same is hereby sustained,

Done at Pasadena, California, this 26th day of October, 1965, by the State Board of Equalization.

_____, Chairman

_____, Member

_____, Member

_____ Member

_____ Member

ATTEST: _____, Acting Secretary